

No. 10164

5/1/42

United States
Circuit Court of Appeals

For the Ninth Circuit.

Vol

2301

GALLATIN FARMERS COMPANY,
a corporation,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Transcript of the Record

Upon Petition to Review a Decision of the United States
Board of Tax Appeals

FILED

AUG 11 1942

PAUL F. O'BRIEN,

CLERK

No. 10164

United States
Circuit Court of Appeals
For the Ninth Circuit.

GALLATIN FARMERS COMPANY,
a corporation,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Transcript of the Record

Upon Petition to Review a Decision of the United States
Board of Tax Appeals

INDEX

[Clerk's Note: When deemed likely to be of an important nature, errors or doubtful matters appearing in the original certified record are printed literally in *italic*; and likewise, cancelled matter appearing in the original certified record is printed and cancelled herein accordingly. When possible an omission from the text is indicated by printing in *italic* the two words between which the omission seems to occur.]

	Page
Answer to Petition for Redetermination of Deficiency	13
Appearances	1
Certificate of Clerk to Transcript of Record..	37
Decision	31
Designation of Contents of Record to Be Cer- tified to United States Board of Tax Appeals	36
Docket Entries	1
Opinion, Memorandum	22
Petition for Redetermination of Deficiency...	3
Exhibit A—Notice of Deficiency.....	5
Petition for Review to United States Circuit Court of Appeals.....	32
Statement of Points to Be Relied Upon, Pe- titioners	39

	Page
Stipulation of Facts.....	14
Exhibits	
A—Copy of Resolution of Stockholders Authorizing Issuance of Preferred Stock, dated January 18, 1938	18
B—Printed Copy of Form of Preferred Stock Certificate in Use During Taxable Year 1939.....	21

APPEARANCES:

For Taxpayer:

J. M. STOTESBURY, Esq.

NORMA E. SKARSTEN, Esq.

For Commissioner:

ALVA C. BAIRD, Esq.

Docket No. 107778

GALLATIN FARMERS COMPANY,

a Corporation,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

DOCKET ENTRIES

1941

June 9—Petition received and filed. Taxpayer notified. (Fee paid.)

June 9—Copy of petition served on General Counsel.

July 30—Answer filed by General Counsel.

July 30—Request for hearing in Helena, Montana, filed by General Counsel.

Aug. 8—Notice issued placing proceeding on Helena, Mont., Calendar. Service of answer and request made.

Aug. 15—Hearing set Sept. 22, 1941, in Helena, Montana.

1941

- Sept. 23—Hearing had before Mr. Arnold on the merits. Submitted. Stipulation of Facts filed—Briefs due Nov. 7, 1941. Reply briefs due Dec. 2, 1941.
- Oct. 7—Transcript of hearing 9/23/41 filed.
- Nov. 3—Stipulation re stock certificate #598 filed.
- Nov. 3—Notice of appearance of Norma E. Skars-ten as counsel filed.
- Nov. 3—Brief filed by taxpayer. 11/4/41 copy served on General Counsel.
- Nov. 4—Brief filed by General Counsel.
- Nov. 28—Reply brief filed by taxpayer.
- Nov. 28—Reply brief filed by General Counsel. Served 11/29/41.
- Nov. 29—Copy of reply brief served on General Counsel.

1942

- Jan. 28—Memorandum opinion rendered, Arnold, Div. 12. Decision will be entered for the respondent. 1/28/42 copy served.
- Jan. 28—Decision entered, Arnold, Div. 12.
- Apr. 20—Petition for review by United States Circuit Court of Appeals, Ninth Circuit, with assignments of error filed by taxpayer.
- Apr. 21—Proof of service filed.
- Apr. 20—Praecipe filed by taxpayer.
- Apr. 30—Affidavit of service of filing petition for review by mail, filed by taxpayer.
- May 28—Proof of service of praecipe filed. [1*]

*Page numbering appearing at top of page of original certified Transcript of Record.

United States Board of Tax Appeals

Docket No. 107778

GALLATIN FARMERS COMPANY,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION

The above-named petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency 90-D, dated April 2, 1941, and as a basis of its proceeding alleges as follows:

1. The petitioner is a corporation, with its principal place of business at Bozeman, Montana. The returns for the periods here involved were filed with the Collector for the District of Montana.

2. The notice of deficiency (a copy of which is attached and marked Exhibit A) was mailed to the petitioner on April 2, 1941.

3. The taxes in controversy are income taxes for the calendar year 1938 in the amount of Ninety-nine and 32/100 Dollars (\$99.32), and for the calendar year 1939 in the amount of Four Hundred Thirteen and 12/100 Dollars (\$413.12), a total [2] amount of Five Hundred Twelve and 44/100 Dollars (\$512.44).

4. The Commissioner erred in assessing the deficiency in the following particulars:

(a) The disallowance of the deduction of \$798.00 for the year ending December 31, 1938, taken by the taxpayer as interest paid or incurred in the course of business.

(b) The disallowance of the deduction of \$798.00 for the year ending December 31, 1939, taken by the taxpayer as interest paid or incurred in the course of business.

(c) The disallowance of the sum of \$3,485.93 taken by the taxpayer as patronage dividends in excess of the amount the Commissioner claims is allowable by law.

5. In support of this petition the taxpayer relies upon the following facts:

(a) The payment of interest in the sum of \$798.00 represents the payment of interest compulsory by action of the stockholders, who, in a meeting held January 18, 1938, declared the preferred stock to be a debt of the corporation, and the payment of interest a definite obligation irrespective of earnings.

(b) The deduction of \$798.00 as interest for the year ending December 31, 1939, was for the same reason and under the same authority as set forth in paragraph (a) hereinabove.

(c) The taxpayer refunded to its customers the sum of \$14,860.30 as patronage dividends for the year ending December 31, 1939. [3]

Wherefore, your petitioner prays that this proceeding be heard and it be determined that there is

no tax due for the years ending December 31, 1938
or December 31, 1939.

(Signed) J. M. STOTESBURY

Counsel for Petitioner.

(Duly verified.) [4]

EXHIBIT A

TREASURY DEPARTMENT
INTERNAL REVENUE SERVICE

Salt Lake City, Utah

Office of
Internal Revenue
Agent in Charge
Salt Lake Division

April 2, 1941.

Gallatin Farmers Company,
125 North Wallace Avenue,
Bozeman, Montana.

Sirs:

Your are advised that the determination of your
income tax liability for the taxable year(s) ended
12/31/38 & 12/31/39 discloses a deficiency of \$512.44
as shown in the statement attached.

In accordance with the provisions of existing in-
ternal revenue laws, notice is hereby given of the
deficiency mentioned.

Within 90 days (not counting Sunday or a legal
holiday in the District of Columbia as the 90th day)
from the date of the mailing of this letter, you may
file a petition with the United States Board of Tax
Appeals for a redetermination of the deficiency.

EXHIBIT A—(Cont.)

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to Internal Revenue Agent in Charge, Salt Lake City, Utah, for the attention of 90D. The signing and filing of this form will expedite the closing of your return(s) by permitting an early assessment of the deficiency, and will prevent the accumulation of interest, since the interest period terminates 30 days after filing the form, or on the date assessment is made, whichever is earlier.

Respectfully,

GUY T. HELVERING,

Commissioner,

By

(Signed) J. P. MARSTELLA

Internal Revenue Agent in Charge.

Enclosures:

Statement.

Form of waiver. [5]

90D

JTG

STATEMENT

Gallatin Farmers Company,
125 North Wallace Avenue,
Bozeman, Montana

Tax Liability for the Taxable Years Ended December 31, 1938 and December 31, 1939

Income Tax	Liability	Assessed	Deficiency
1938	\$372.42	\$273.10	\$ 99.32
1939	413.12	None	413.12
	<hr/>	<hr/>	<hr/>
Totals.....	\$785.54	\$273.10	\$512.44

EXHIBIT A—(Cont.)

In making this determination of your income tax liability, careful consideration has been given to the report of examination dated May 18, 1940; to your protest dated December 3, 1940; and to information contained in your letter dated February 14, 1941.

In your protest it is claimed that you are entitled to exemption from taxation under the provisions of Section 101(12) of the 1938 Revenue Act and Internal Revenue Code. Based on information and data previously submitted by you to the Bureau and after careful consideration, it was ruled that you were not entitled to exemption. Since that time no information has been submitted to show any material change in the character of your organization or your method of doing business. It is accordingly held that you are not entitled to exemption from taxation as claimed.

A copy of this letter and statement has been mailed to your representative, Mr. J. M. Stotesbury, Bozeman, Montana, in accordance with the authority contained in the power of attorney executed by you and on file with the Bureau. [6]

Taxable Year Ended December 31, 1938

ADJUSTMENTS TO NET INCOME

Net income as disclosed by return.....		\$2,184.78
Unallowable deductions and additional income		
(a) Interest on preferred stock.....	\$ 798.00	
(b) Cancellation of check.....	18.52	816.52
	<hr/>	<hr/>
Total		\$3,001.30

EXHIBIT A—(Cont.)

Nontaxable income and additional
deductions

(c) Additional allowance for ex- penses	21.95
--	-------

Net income adjusted.....	\$2,979.35
--------------------------	------------

EXPLANATION OF ADJUSTMENTS

(a) In your return for the year 1938, a deduction of \$798.00 for interest on preferred stock was claimed. A like deduction for interest paid on preferred stock was also claimed in your 1939 return. This deduction for each year for so-called interest on preferred stock is disallowed on the ground that such in reality was a dividend paid on your preferred stock and therefore not an allowable interest deduction paid on indebtedness as provided by Section 23(b) of the 1938 Revenue Act and Section 23(b) of the Internal Revenue Code.

(b) A check issued in 1937 for this amount and charged to expense on your books and return for that year was cancelled during the taxable year 1938. This amount is therefore treated as taxable income for the latter year.

(c) Adjustment is made to allow as a deduction expense items aggregating \$21.95, which were charged to Surplus Account on your books and not claimed as a deduction in your return for the taxable year. [7]

COMPUTATION OF TAX

Excess-profits tax:

Taxable net income.....	\$2,979.35
Less: 10% of \$40,000.00 value of capital stock as declared in your capital stock tax return for year ended June 30, 1938.....	4,000.00

Net income subject to excess-profits tax..... None

Excess-profits tax assessed:

Original, Account No. 41104..... None

Income tax:

Taxable net income.....	\$2,979.35
Less: Excess-profits tax	None

Special class net income..... \$2,979.35

Tax at 12½% on \$2,979.35—total tax.....\$ 372.42

Income tax assessed:

Original, Account No. 41104..... 273.10

Deficiency of income tax..... \$ 99.32

Taxable Year Ended December 31, 1939

ADJUSTMENTS TO NET INCOME

Loss as disclosed by return..... (\$1,132.35)

Unallowable deductions and
additional income

(a) Interest on preferred stock.....	\$ 798.00	
(b) Recovery on bad debt.....	10.00	
(c) Profit on sale of truck.....	50.00	
(d) Excessive patronage dividends	3,485.93	
(e) Accrued capital stock tax.....	42.00	
(f) Montana corporation license tax	59.12	4,445.05

Total \$3,312.70

Nontaxable income and additional
deductions

(g) Adjustments to Accounts Receiv-
able 7.77

Net income adjusted..... \$3,304.93

EXHIBIT A—(Cont.)

EXPLANATION OF ADJUSTMENTS

(a) This deduction is disallowed for the reasons given in connection with item (a) of the statement for the preceding year ended December 31, 1938.

(b) In the year 1938 a deduction for a bad debt was claimed by you. In the year 1939 the debtor gave to you his common stock, par value \$10.00, in part payment of the debt, which stock was thereupon cancelled by you. This recovery is held to be taxable income for the year 1939.

(c) In the year 1939 an old truck fully exhausted by depreciation allowances was sold for \$50.00. This amount was credited to an asset account on your books and not reported as income in your 1939 return. Adjustment is made to reflect this amount in taxable income for that year.

(d) In your return for the taxable year ended December 31, 1939, a deduction for patronage dividends in the amount of \$14,860.30 was claimed. It is determined that the patronage dividends allowable as a deduction for the taxable year amounted to \$11,374.37, computed as shown below, and the excess amount claimed, or \$3,485.93, is therefore disallowed:

COMPUTATION OF DEDUCTIBLE PATRONAGE
DIVIDENDS

Loss per books after deducting patronage dividends	(\$ 1,132.35)
--	---------------

EXHIBIT A—(Cont.)

Additions:

Patronage dividends deducted.....	\$14,860.30	
Dividends paid on preferred stock	798.00	
Recovery on bad debt.....	10.00	
Profit on sale of truck.....	50.00	
Capital stock tax.....	42.00	
Accrued corporation license tax....	59.12	
Income tax refund — nontaxable income	995.77	16,815.19
		<hr/>
Total		\$15,682.84

Deductions:

Income tax for 1934.....	\$ 572.25	
Income tax for 1938.....	273.10	
Adjustment of Accounts Receivable	7.77	853.12
		<hr/>

Income as adjusted..... \$14,829.72
[9]

Brought forward — Income as ad-
justed

\$14,829.72

Distributions:

6% dividend payable on common stock	\$ 1,183.20	
6% dividend payable on preferred stock	798.68	
Provision for Reserve fund.....	755.63	
Provision for Educational fund....	717.84	3,455.35
		<hr/>

Income available for patronage
dividends

\$11,374.37

Patronage dividends claimed as a
deduction on your books and in
your return

14,860.30

Adjustment for excessive patronage
dividends

\$ 3,485.93

(e) The amount of \$42.00, representing accrued capital stock tax for the capital stock tax fiscal year

EXHIBIT A—(Cont.)

ended June 30, 1939, was properly claimed as a deduction in your return for the year 1938 and was allowed. The amount, however, was not entered on your books until 1939. This amount, in error, was again claimed as a deduction in your 1939 return and is disallowed.

(f) An amount of \$59.12 representing Montana corporation license tax for 1938 was properly claimed as a deduction in your 1938 return and allowed, although not entered on your books until 1939. This same amount, in error, was deducted in your 1939 return and is disallowed.

(g) A deduction of \$7.77 is allowed in order to bring your Accounts Receivable Control account into agreement with the actual list of accounts receivable.

COMPUTATION OF TAX

Excess-profits tax:

Taxable net income.....	\$ 3,304.93
Less: 10% of \$42,979.35* adjusted value of capital stock for capi- tal stock tax fiscal year ended June 30, 1939.....	4,297.94
	<hr/>
Net income subject to excess-profits tax	None
Excess-profits tax assessed:	
Original, Account No. NC-86769.....	None
*Declared value of capital stock for capital stock tax fiscal year 6/30/38	\$40,000.00
Net income for 1938.....	2,979.35
	<hr/>
Adjusted value of capital stock..	\$42,979.35

EXHIBIT A—(Cont.)

Income tax:	
Taxable net income.....	\$ 3,304.93
Less: Excess-profits tax	None
	<hr/>
Special class net income.....	\$ 3,304.93
Tax at 12½% on \$3,304.93.....	\$ 413.12
Income tax assessed:	
Original, Account No. NC-86769.....	None
	<hr/>
Deficiency of income tax.....	\$ 413.12

[Endorsed]: Filed Jun. 9, 1941. [11]

[Title of Board and Cause.]

ANSWER

Comes now the Commissioner of Internal Revenue, respondent above named, by his attorney, J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, and for answer to the petition filed by the above-named petitioner admits and denies as follows:

1. Admits the allegations contained in paragraph 1 of the petition.
2. Admits the allegations contained in paragraph 2 of the petition.
3. Admits the allegations contained in paragraph 3 of the petition.
4. (a) to (c), inclusive. Denies that the Commissioner erred as alleged in subparagraphs (a) to (c), inclusive, of paragraph 4 of the petition. [12]
5. (a) to (c), inclusive. Denies the allegations

contained in subparagraphs (a) to (c), inclusive, of paragraph 5 of the petition.

6. Denies generally and specifically each and every allegation in the petition not hereinbefore admitted, qualified or denied.

Wherefore, it is prayed that the Commissioner's determination be approved and the petitioner's appeal denied.

(Signed) J. P. WENCHEL

Chief Counsel,

Bureau of Internal Revenue.

Of Counsel:

ALVA C. BAIRD,

Division Counsel,

T. M. MATHER,

HARRY R. HORROW,

Special Attorneys,

Bureau of Internal Revenue.

HRH/vg 7-25-41

[Endorsed]: Filed Jul. 30, 1941.] [13]

—————

[Title of Board and Cause.]

STIPULATION OF FACTS

The parties hereto through their respective counsel hereby stipulate and agree that the statement set forth below is true and that it may be accepted by the Board as its findings of facts in this proceeding:

I.

The petitioner is a corporation incorporated and

operating under the provisions of Chapter 38 of the Civil Code of the State of Montana.

II.

The petitioner kept its accounts and filed its income tax returns on the accrual basis.

III.

During the taxable years 1938 and 1939, the petitioner had common stock outstanding as follows:

[14]

January 1, 1938.....	Common Stock (par value).....	\$18,940.00
December 31, 1938.....	Common Stock (par value).....	19,515.00
December 31, 1938.....	Common Stock (par value).....	19,495.00

IV.

That on January 18, 1938, the stockholders authorized the issuance of preferred stock in accordance with a resolution, a copy of which is hereinafter attached as Exhibit A.

V.

Pursuant to said resolution preferred stock was issued during the year 1938 so that as of December 31, 1938, and December 31, 1939, there was issued and outstanding preferred shares of the par value of \$13,300.00.

VI.

During each of the taxable years 1938 and 1939 there was paid the preferred stockholders \$798.00, which was claimed by the petitioner as a deduction on its returns for those years as interest paid and which amounts were disallowed by the Commissioner on the ground that such sums constituted dividends.

VII.

That there was accrued on the books of the petitioner as patronage dividends at the end of the calendar year 1939 the sum of \$14,860.30, which sum was paid subsequent to the close of the taxable year 1939. [15]

VIII.

During the calendar year 1939, the petitioner declared and paid out of prior years' earnings the sum of \$1,183.20, which was a 6 per cent dividend on the common stock for the year ended December 31, 1939.

IX.

The net income for the taxable year 1939, after deducting the amount of \$798.00 paid on preferred stock, claimed as a deduction for interest on the petitioner's return for said year, is the amount of \$14,031.72. The Commissioner has disallowed as a deduction the said sum of \$798.00, deducted as interest by the petitioner for the taxable year 1939, on the grounds that said sum is a dividend on preferred stock, and the net income for said year as so adjusted is the sum of \$14,829.72 before making provision for the following amounts which the Commissioner has held must be provided for before the payment of patronage dividends:

6% Dividend on Common Stock.....	\$ 1,183.20
6% Dividend on Preferred Stock.....	798.00
Provision for reserve fund—	
5% of \$12,848.52.....	642.43
Provision for educational fund—	
5% of \$12,206.09.....	610.30

X.

The surplus (reserve) of the petitioner as of December 31, 1939, prior to the deduction therefrom of the dividend paid on [16] common stock in the amount of \$1,183.20, the payment on preferred stock in the amount of \$798.00 and the inclusion therein of the profit or the deduction therefrom of any loss from operations for the taxable year 1939 is the amount of \$7,910.18.

XI.

No amount was set aside from current earnings as an addition to the reserve in the taxable year 1939.

No amount has ever been set aside as an educational fund.

XII.

It is agreed that the parties hereto will file, as Exhibit B to this stipulation, a printed copy of the form of preferred stock certificate in use during the taxable year 1939.

J. M. STOTESBURY,
Counsel for Petitioner.

J. P. WENCHEL,
Chief Counsel,
Bureau of Internal Revenue.
Counsel for Respondent.

EXHIBIT A

“Whereas, Paragraph six of the original articles of Incorporation of the Gallatin Valley Co-operative Company provide that “The amount of authorized capital stock of said corporation shall be Fifty Thousand Dollars (\$50,000.00) all of which shall be common stock and non-assessable, and divided into seven (7) different classes as to par value as follows:

175	shares	of	the	par	value	of	\$90.00	each	being	\$15,750.00
24	“	“	“	“	“	“	75.00	“	“	1,800.00
25	“	“	“	“	“	“	60.00	“	“	1,500.00
50	“	“	“	“	“	“	45.00	“	“	2,250.00
150	“	“	“	“	“	“	30.00	“	“	4,500.00
250	“	“	“	“	“	“	15.00	“	“	3,750.00
2,045	“	“	“	“	“	“	10.00	“	“	20,450.00

Total authorized capital stock.....50,000.00’’and

It is deemed to the best interests of the corporation that its authorized capital stock be changed; Now Therefore Be It Resolved:

That Paragraph six of the Articles of Incorporation be amended and is hereby amended to read as follows:

“The amount of the Authorized capital stock of said corporation shall be Fifty Thousand Dollars (\$50,000.00) divided into Thirty Thousand Dollars (\$30,000.00) common stock and non-assessable divided into seven (7) different classes as to par value as follows:

EXHIBIT A—(Cont.)

123 shares of the par value of \$90.00 each being \$11,070.00							
24	“	“	“	“	75.00	“	“
25	“	“	“	“	60.00	“	“
50	“	“	“	“	45.00	“	“
100	“	“	“	“	30.00	“	“
250	“	“	“	“	15.00	“	“
663	“	“	“	“	10.00	“	“

Total authorized common stock.....30,000.00; and

Twenty Thousand Dollars (\$20,000.00) of Preferred Stock, consisting of one Class of Two Thousand (2,000) shares of the par value of Ten Dollars (\$10.00) per share. Said preferred stock to be non-assessable, non-participating; annual dividends to be cumulative and at the rate of six (6) per centum on the par value. Said preferred stock to be subject to call and redemption at par plus unpaid accumulated dividends at any time by order of the Board of Directors of said corporation. Upon dissolution or liquidation of this corporation said preferred stock shall be retired at par value plus accumulated dividends before any payment is made on common stock.” [18]

That the President and Secretary of this corporation be, and they hereby are, authorized to execute and file with the County Clerk and Recorder of the County of Gallatin, and with the Secretary of State of the State of Montana, the proper certificate showing the change in the authorized capital stock of said corporation.”

Motion was made by John Paugh, seconded by

EXHIBIT A—(Cont.)

E. J. S. Moore, and unanimously carried that the resolution be adopted as read, it being understood and explained that the preferred stock would be a debt of the Corporation, the dividend to be in the form of interest payable annually regardless of earnings, and that the Board of Directors could issue the said preferred stock as they deemed necessary, and redeem it as the finances of the Corporation permitted.

[Endorsed]: Filed Sep. 23, 1941. [19]

[Title of Board and Cause.]

STIPULATION

Pursuant to paragraph 12 of the Stipulation of Facts heretofore filed in the above-mentioned proceeding, it is stipulated and agreed that the attached form of stock certificate no. 598 is a copy of the form of preferred stock certificate in use by the petitioner during the year 1939.

J. M. STOTESBURY

Counsel for Petitioner.

J. P. WENCHEL,

ACB

Chief Counsel,

Bureau of Internal Revenue,

Counsel for Respondent.

ACB/mm 10/25/41 [20]

EXHIBIT B

Incorporated Under the Laws of
No. 600 the State of Montana Shares....

GALLATIN FARMERS COMPANY

A Cooperative Association

Authorized Capital—Common \$30,000

Preferred \$20,000

This Certifies that is the owner of
Preferred Shares of the Capital Stock of

Gallatin Farmers Company, Belgrade, Montana
transferable only on the books of the Corporation
by the holder hereof in person or by Attorney, upon
surrender of this Certificate properly endorsed.

In Witness Whereof, the said Corporation has
caused this Certificate to be signed by its duly au-
thorized officers and to be sealed with the Seal of the
Corporation.

this day of A. D. 19...

.....
Secretary. President.

Shares

\$10

Each

[21]

For Value Received, hereby sell, assign
and transfer unto

.....
Shares of the Capital Stock represented by the
within Certificate, and do hereby irrevocably con-
stitute and appoint

.....

EXHIBIT B—(Cont.)

to transfer the said Stock on the books of the within named Corporation with full power of substitution in the premises.

Dated 19...

In presence of

.....

Notice. The signature of this assignment must correspond with the name as written upon the face of the certificate, in every particular without alteration or enlargement, or any change whatever.

[Endorsed]: Filed Nov. 3, 1941. [22]

Docket No. 107778

[Title of Board and Cause.]

MEMORANDUM OPINION

Arnold: This proceeding involves deficiencies in income taxes for the calendar years 1938 and 1939 in the respective amounts of \$99.32 and \$413.12. Two issues are presented, namely, (1) whether respondent erred in disallowing a \$798 deduction claimed in each year as interest paid or incurred in the course of business, and (2) whether respondent erred in disallowing \$3,485.93 as excessive patronage dividends claimed as a deduction by petitioner for 1939. The parties filed a stipulation of facts which we adopt as our findings of fact hereinafter setting forth such portions thereof as are necessary for a determination of the issues presented.

Petitioner is a Montana corporation with its principal place of business at Bozeman, Montana. It filed its income tax returns with the collector of internal revenue for the district of Montana. Its accounts were kept and its tax returns filed on the accrual basis.

Petitioner was incorporated and operates under the provisions of Chapter 38 of the Civil Code of the State of Montana.

During the taxable years petitioner had common stock outstanding as follows:

January 1, 1938.....	Common stock (par value).....	\$18,940.00
December 31, 1938.....	“ “ “ “	19,515.00
December 31, 1938.....	“ “ “ “	19,495.00

Prior to January 18, 1938 petitioner's authorized capital was \$50,000 of common stock divided into seven different classes of varying par values. On the latter date petitioner's stockholders amended the articles of incorporation so as to provide for \$30,000 of common stock of the same par values, and \$20,000 of preferred stock consisting of one class of 2,000 shares, par value \$10 per share. The resolution provided in part as follows:

* * * Said preferred stock to be non-assessable, non-participating; annual dividends to be cumulative and at the rate of six (6) per centum on the par value. Said preferred stock to be subject to call and redemption at par plus unpaid accumulated dividends at any time by order of the Board of Directors of said corporation. Upon dissolution or liquidation of this

corporation said preferred stock shall be retired at par value plus accumulated dividends before any payment is made on common stock.

* * * * *

Motion was made * * *, and unanimously carried that the resolution be adopted as read, it being understood and explained that the preferred stock would be a debt of the Corporation, the dividend to be in the form of interest payable annually regardless of earnings, and that the Board of Directors could issue the preferred stock as they deemed necessary, and redeem it as the finances of the Corporation permitted.

[23]

Pursuant to said resolution preferred stock was issued during 1938 so that as of December 31, 1938 and 1939 there was preferred stock of the par value of \$13,300.00.

The face of the preferred stock certificate reads as follows:

Incorporated Under the Laws of
No. 598 the State of Montana Shares.....

GALLATIN FARMERS COMPANY

A Cooperative Association
Authorized Capital—Common \$30,000
Preferred \$20,000

This Certifies that is the owner of
Preferred Shares of the Capital Stock of
Gallatin Farmers Company, Belgrade, Montana
transferable only on the books of the Corporation

by the holder hereof in person or by Attorney, upon surrender of this Certificate properly endorsed.

In Witness Whereof, the said Corporation has caused this Certificate to be signed by its duly authorized officers and to be sealed with the Seal of the Corporation.

this day of A. D. 19...

.....
Secretary. President.

Shares
\$10
Each

Superimposed on the face of the certificate in large red letters is the word "Preferred". The back of the certificate reads as follows:

For Value Received, hereby sell, assign and transfer unto

.....
Shares of the Capital Stock represented by the within Certificate, and do hereby irrevocably constitute and appoint

.....
to transfer the said Stock on the books of the within named Corporation with full power of substitution in the premises.

Dated 19...

In presence of

.....

During each of the taxable years there was paid the preferred stockholders \$798.00, which amount was deducted on the return for each year as interest paid. Said deductions were disallowed by respondent on the ground that such sums constituted dividends.

At the end of the calendar year 1939 petitioner accrued on its books as patronage dividends the sum of \$14,860.30 which was paid subsequent to December 31, 1939.

During 1939 petitioner declared and paid out of prior years' earnings the sum of \$1,183.20, which was a 6 per cent dividend on the common stock for the year ended December 31, 1939.

Petitioner's income for 1939 after deducting the \$798.00 paid on preferred stock was \$14,031.72. Respondent adjusted petitioner's net income to \$14,829.72 by disallowing the claimed deduction of \$798.00. From the net income as so adjusted respondent held that provision must be made for the following amounts before the payment of patronage dividends:

6 per cent dividend on common stock.....	\$ 1,183.20
6 per cent dividend on preferred stock.....	798.00
Provision for reserve fund	
5 per cent of \$12,848.52.....	642.43
Provision for educational fund	
5 per cent of \$12,206.09.....	610.30

The surplus (reserve) of the petitioner as of December 31, 1939, prior to the deduction therefrom of the common stock dividend of \$1,183.20, the pay-

ment on preferred stock of \$798.00 and the inclusion therein of profit or deduction therefrom of any loss from operations for 1939 is the amount of \$7,910.18. [24]

No amount was set aside from current earnings as an addition to the reserve in 1939.

No amount has ever been set aside as an educational fund.

The first issue is whether the payments made during the taxable years on petitioner's "preferred stock" were payments of dividends or interest. Petitioner contends that actually a debt was created and the payments were interest payments. Petitioner cites and relies upon *Commissioner v. Proctor Shop, Inc.*, 82 Fed. (2d) 792, affirming 30 B. T. A. 721, and *Arthur R. Jones Syndicate v. Commissioner*, 23 Fed. (2d) 833.

We have carefully weighed and considered the evidence adduced and petitioner's argument and authorities, but we are not convinced that the preferred stock issue represented an indebtedness. The issuance of preferred stock was a method, authorized by Montana law, as hereinafter shown, whereby petitioner was able to obtain funds for the enterprise without borrowing money or contracting a debt, the stockholder being preferred as to principal and dividends but without voice in the management of the corporation. *Elko Lamoille Power Co. v. Commissioner*, 50 Fed. (2d) 595; *Finance & Investment Corporation v. Burnet*, 57 Fed. (2d) 444.

Petitioner was organized under Chapter 38 of the

Civil Code of Montana, section 6381 of which (Revised Codes of Montana, 1935) authorizes cooperative associations to divide their capital stock into shares of preferred and common. Said section provides that the holders of preferred stock shall have no voting power and shall not participate in the management and affairs of the association, but it also provides that the owners of preferred stock "shall share in the profits of the association to the extent of not exceeding six percent (6%) per annum on the par value thereof." (Emphasis supplied.) This petitioner and "profits of the association" available for preferred dividends in excess of \$798 per year, since it is stipulated that \$1,183.20 was paid on common in 1939 out of prior years' earnings and that 1939 net income, after deducting the \$798 paid on preferred, amounted to \$14,031.72. Therefore, the distributions to preferred stockholders in each taxable year would be "dividends" within the meaning of the taxing statute, section 115 (a), Revenue Act of 1938, and would be "profits of the association" within the meaning of the Montana Civil Code, section 6381, *supra*.

We can find no word, phrase or figure in the preferred stock certificate which supports petitioner's contention that the amounts paid preferred stockholders were interest payments. Neither the amendment of the articles of incorporation nor the preferred stock certificates indicate anything out of the ordinary and usual relation in the issuance of preferred stock. The certificates recite on their face

that petitioner's authorized capital is \$30,000 common and \$20,000 preferred, that the party whose name appears on the face is the owner of a stated number of preferred shares of petitioner's capital stock which is transferable on the books of the petitioner by the holder or his attorney in the usual manner. On the back of the certificate appears the usual form for endorsement over of the certificate. In our opinion any holder or transferee of the certificate would be justified in believing that said certificate was what it purported to be, namely, a certificate of preferred stock, and he would not be put on notice by the certificate that it evidenced any indebtedness of the petitioner. Obviously, if he were a preferred stockholder he was not a creditor of the petitioner. *Elko Lamoille Power Co. v. Commissioner, supra.*

The evidence which petitioner emphasizes is that portion of the minutes which reads as follows: "it being understood and explained that the preferred stock would be a debt of the Corporation, the dividend to be in the form of interest payable annually regardless of earnings, * * *." This evidence stands alone in support of petitioner's contention. Its significance can be measured by the fact that no such provision appears in the charter amendment or in petitioner's by-laws. Petitioner has advanced no other reason why the preferred stock issue should be considered a loan or security for a loan. Furthermore, if an indebtedness was intended there should be a fixed date at which the indebtedness would ma-

ture, but the redemption of the preferred stock here was entirely at the option of the directors who could issue the stock as they deemed necessary and redeem it at any time.

The Board has considered this question with respect to other cooperative enterprises and has held that amounts paid on so-called preferred stock were dividends rather than interest. The Trego County Cooperative Association, 6 B. T. A. 1275; The Farmers Cooperative Association, 5 B. T. A. 61; Sacred Heart Cooperative Mercantile Co., 2 B. T. A. 24. See also Greensboro News Company, 31 B. T. A. 812. On this issue respondent's determination is approved.

The second issue is whether respondent erred in disallowing \$3,485.93 of the deduction for patronage dividends claimed by petitioner for 1939. The issue, as presented, is equivalent to a request that we increase the deduction for patronage dividends by \$3,485.93 over the amount allowed by respondent. In *Co-Operative Oil Ass'n. Inc. v. Commissioner*, 115 Fed. (2d) 666, the Circuit Court of Appeals for the Ninth Circuit considered and denied a similar request except that the taxpayer there had earned but had not distributed the "patronage dividends" to its members. We think the fact that the patronage dividends here were subsequently distributed is insufficient to distinguish this proceeding from the rule laid down by the Ninth Circuit as follows:

Petitioner makes no attempt to show that it is the object of legislative grace by pointing to a statute authorizing the deduction. The Con-

gress has not legislated the deduction, and the courts can not usurp that function. Whether respondent [Commissioner of Internal Revenue] should have allowed the deduction he did not allow is a question upon which we express no opinion.

In view of this authority it is immaterial how respondent determined the deduction he would allow for patronage dividends. It is sufficient for present purposes that we can find no statutory authority for increasing the deduction that respondent has allowed.

Decision will be entered for the respondent.

[Seal]

Entered: January 28, 1942. [25]

United States Board of Tax Appeals
Washington

Docket No. 107778

GALLATIN FARMERS COMPANY,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

DECISION

Pursuant to the determination of the Board, as set forth in its memorandum opinion entered January 25, 1942, it is

Ordered and Decided: That there are deficiencies in income tax for the calendar years 1938 and 1939 in the respective amounts of \$99.32 and \$413.12.

Enter:

(Signed) WILLIAM W. ARNOLD
Member.

Entered Jan. 28, 1942. [26]

[Title of Board and Cause.]

PETITION FOR REVIEW TO THE UNITED
STATES CIRCUIT COURT OF APPEALS
FOR THE NINTH CIRCUIT.

To the Honorable Judges of the United States Circuit Court of Appeals for the Ninth Circuit:

Comes now Gallatin Farmers Company, Petitioner on Review, by its attorneys, J. M. Stotesbury and Norma E. Skarsten, and respectfully shows:

I.

The Petitioner on Review (hereinafter referred to as "Petitioner") is a corporation organized and existing under and by virtue of the laws of the State of Montana, with its principal place of business at Bozeman, Montana. The Respondent on Review (hereinafter referred to as the "Commissioner") is the duly appointed, qualified and acting Commissioner of Internal Revenue of the United States, holding his office by virtue of the laws [27] of the United States.

II.

The nature of the controversy is as follows:

The petitioner contended before the United States Board of Tax Appeals:

(a) That it was entitled to deduct from its gross income, in arriving at its net income for taxation, the sum of \$798.00 for both the years ending December 31, 1938, and December 31, 1939, as interest paid or incurred in the course of business, this being the amount paid on so-called preferred stock, which a meeting of the stockholders of the Petitioner had declared to be a debt of the Petitioner. The Board of Tax Appeals failed to find that these amounts were interest, but found that these amounts were dividends on stock, and not deductible from gross income to determine net income for purposes of taxation.

(b) The Petitioner contended before the United States Board of Tax Appeals that it was entitled to deduct the sum of \$14,860.30, as patronage dividends, from gross income to arrive at net income subject to income tax. The Commissioner contended that, before determining the amount available for patronage dividends, the petitioner must make provision for the following payments, pursuant to Chapter 38 of the Civil Code of Montana:

6% dividend on common stock.....	\$ 1,183.20
6% dividend on preferred stock.....	798.00

[28]

Provision for reserve fund, 5% of \$12,848.52.....	642.43
Provision for educational fund, 5% of \$12,206.09.....	610.30

The cause was submitted on an agreed stipulation of facts, whereby it was stipulated that Petitioner's net income, after restoring the \$798.00 deducted as interest, was the sum of \$14,829.72; that Petitioner accrued as patronage dividends the sum of \$14,860.30 at December 31, 1939, which was subsequently paid to patrons.

The Board of Tax Appeals failed to find on this issue at all, and failed to decide the question presented, which is: May the Petitioner deduct as patronage dividends all of its earnings in any year, or must it first provide for dividends on preferred and common stock, reserve fund, and educational fund, out of current years' earnings, before determining the amount available for patronage dividends?

III.

The Petitioner, being aggrieved by the decision of the United States Board of Tax Appeals, desires a review of said decision by the United States Circuit Court of Appeals for the Ninth Circuit, within which Circuit is located the office of the Collector of Internal Revenue with whom Petitioner filed its income tax returns for the years ending December 31, 1938, and December 31, 1939. The decision of the United States Board of Tax Appeals, ordering and deciding that there are deficiencies in income tax for the calendar years 1938 and 1939 [29] in the respective amounts of \$99.32 and \$413.12, was entered on January 28, 1942.

IV.

The Petitioner says that in the record and proceedings before the United States Board of Tax Appeals, and in the decision rendered and entered by said Board, manifest errors occurred and intervened, to the prejudice of Petitioner, and Petitioner assigns the following errors, and each of them, which, it avers, occurred in said record, proceedings, decision, and final order so rendered and entered by the said United States Board of Tax Appeals, to-wit:

1. The United States Board of Tax Appeals erred by deciding that Petitioner owed an income tax for the year ending December 31, 1938, in the sum of \$99.32, by failing to permit Petitioner to deduct interest in the sum of \$798.00 paid on the debt represented by preferred stock.

2. The United States Board of Tax Appeals erred by deciding that Petitioner owed an income tax for the year ending December 31, 1939, in the sum of \$413.12, by failing to allow the aforesaid deduction of \$798.00 for the year ending December 31, 1939, and for failure to allow Petitioner to deduct from gross income the sum of \$14,860.30 accrued as patronage dividends payable for the year ending December 31, 1939.

Wherefore, the Petitioner prays that the decision of the United States Board of Tax Appeals entered herein be reviewed by the United States Circuit Court of Appeals for the [30] Ninth Circuit, and

that a transcript of the record be prepared in accordance with law and with the rules of said Court, and transmitted to the Clerk of said Court for filing, and that appropriate action be taken to the end that the errors complained of may be reviewed and corrected by said Court.

Respectfully submitted,

J. M. STOTESBURY

Bozeman, Montana

NORMA E. SKARSTEN

Bozeman, Montana

Counsel for Petitioner.

(Duly verified.)

[Endorsed]: Filed Apr. 20, 1942. [31]

[Title of Board and Cause.]

PETITIONER'S DESIGNATION OF CONTENTS OF RECORD TO BE CERTIFIED BY CLERK OF THE UNITED STATES BOARD OF TAX APPEALS.

Comes now the Petitioner, having filed its Petition for Review in the above-entitled cause, and designates as the contents of the record to be certified to the United States Circuit Court of Appeals for the Ninth Circuit, the following:

1. The Petition.
2. The Answer.
3. The stipulation of facts, including Exhibits "A" and "B".

4. Memorandum Opinion.
5. Decision.

Dated at Bozeman, Montana, this 16th day of April, 1942.

J. M. STOTESBURY
NORMA E. SKARSTEN
Counsel for Petitioner.

J. M. STOTESBURY
NORMA E. SKARSTEN
P. O. Box 694
Bozeman, Montana.

[Endorsed]: Filed Apr. 20, 1942. [32]

Service of the foregoing Designation of Contents of Record is hereby admitted and agreed to this 28th day of May, 1942.

J. P. WENCHEL,
W
Chief Counsel, Bureau of
Internal Revenue.

[Endorsed]: Filed May 28, 1942. [33]

Docket No. 107778

[Title of Board and Cause.]

CERTIFICATE TO TRANSCRIPT OF
RECORD

I, B. D. Gamble, clerk of the U. S. Board of Tax Appeals, do hereby certify that the foregoing pages,

1. to 33, inclusive, contain and are a true copy of the transcript of record, pages, and proceedings on file and of record in my office as called for by the Praecipe in the appeal (or appeals) as above numbered and entitled.

In testimony whereof, I hereunto set my hand and affix the seal of the United States Board of Tax Appeals, at Washington, in the District of Columbia, this 29th day of May, 1942.

[Seal]

B. D. GAMBLE

Clerk,

United States Board of Tax Appeals.

[Endorsed]: No. 10164. United States Circuit Court of Appeals for the Ninth Circuit. Gallatin Farmers Company, a Corporation, Petitioner, vs. Commissioner of Internal Revenue, Respondent. Transcript of the Record. Upon Petition to Review a Decision of the United States Board of Tax Appeals.

Filed June 15, 1942.

PAUL P. O'BRIEN

Clerk of the United States Circuit Court of Appeals
for the Ninth Circuit.

In the United States Circuit Court of Appeals
For the Ninth Circuit

No. 10164

GALLATIN FARMERS COMPANY,
a Corporation,

Petitioner on Review,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent on Review.

PETITIONER'S STATEMENT OF POINTS TO
BE RELIED UPON.

Comes now the petitioner on review and adopts as its statement of points to be relied upon on the above entitled appeal, the assignments of error which now appear in the record as a part of the petition to review.

Dated at San Francisco, California, this 20th day of July, 1942.

J. M. STOTESBURY

NORMA E. SKARSTEN

Counsel for Petitioner on Review.

2450 Union Street,
San Francisco, California.

[Endorsed]: Filed Jul. 21, 1942, Paul P. O'Brien,
Clerk.

